BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

December 17, 2001

ALAN GREENSPAN
CHAIRMAN

The Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Board of Governors of the Federal Reserve System is pleased to forward for your consideration the enclosed legislative proposal to facilitate check truncation, along with a section-by-section analysis of the proposed law. The proposed Check Truncation Act is designed to foster payment system innovation and enhance the efficiency of the payments system by reducing some of the legal impediments to check truncation that exist under current law. An overview of the proposed Act is also enclosed.

The draft legislation reflects substantial input from the banking industry, consumer groups, and others. In its simplest terms, it would enable banks to achieve many of the benefits of electronic check processing without mandating the receipt of checks in electronic form. Banks would be able to truncate, or stop, the flow of checks, process them electronically, and create machine-readable substitute checks, if necessary, that would be the legal equivalent of the original checks.

The proposed legislation should improve the efficiency of the payments system by enabling banks to expand the use of electronics in the collection and return of checks, reducing the industry's reliance on transportation to move checks across the nation. Had the provisions of this proposed Act been in effect when air traffic came to a standstill due to the terrorist attacks on September 11, banks would have been able to reduce the impact of the disruption in air transportation on the check collection system.

The Board believes the proposed Check Truncation Act will help the nation move to a more efficient payments system and appreciates your consideration of this legislation.

Sincerely,

(signed) Alan Greenspan

Enclosures

Identical letters also sent to:
The Honorable Phil Gramm, Ranking Member, Committee on Banking, Housing, and Urban Affairs; and
The Honorable Michael G. Oxley, Chairman, and The Honorable John J. LaFalce, Ranking Member, Committee on Financial Services, U.S. House of Representatives.

Overview of the Check Truncation Act

The Federal Reserve Board has developed a draft federal law, the proposed Check Truncation Act, that would remove certain legal impediments to check truncation and would enhance the overall efficiency of the nation's payments system. Current law requires banks to physically present and return the original checks unless they have obtained agreements to do so electronically. Banks, however, have found it difficult to obtain such agreements on a large scale, which has hampered the industry's ability to achieve substantial further improvements in the check collection and return process.

The proposed Act is designed to facilitate check truncation without mandating the receipt of checks in electronic form. Under the provisions of the proposed Act, banks could agree, as they can today, to send check images or information to each other electronically rather than exchanging the original checks. The legislation would permit banks to use electronics to streamline the check collection and return process even in cases in which they do not have electronic exchange agreements. The proposed Act facilitates this expanded use of electronics by creating a new instrument, called a "substitute check," that can be created from an electronic check image and that would be the legal equivalent of the original check. Substitute checks could be processed by receiving banks just as original paper checks are today, thereby not significantly affecting the operations of banks that do not wish to participate in the electronic collection or return of checks.

In drafting this proposed law, the Federal Reserve Board attempted to strike a fair balance among the competing interests of various payments system participants. It strove to ensure, to the extent practicable, that a bank and its customer would be in substantially the same legal and practical position regardless of whether or not they received the original check. It did this through the proposed Act's warranty, indemnity, and expedited recredit provisions, which provide rights to recipients of substitute checks in the event that they incur a loss due to the receipt of a substitute check instead of the original check.

The Federal Reserve Board believes that the proposed legislation may result in substantial payments system benefits. Banks could use substitute checks to collect and return checks more quickly and to reduce the banking industry's reliance on the physical transportation of checks. Banks might also be able to reduce their infrastructure costs because their branch and ATM networks would no longer need to be tied geographically to their processing centers. Banks' customers may also benefit from these infrastructure changes if they enable banks to offer broader deposit options, later cutoff hours, more timely information, and faster check collection and return.